IN THE

Supreme Court of the United States

October Term, 1933

No. 227

MARSHALL S. REYNOLDS, Individually and as Collector of Internal Revenue, PETITIONER

v.

RICHARD F. COOPER

No. 228

MARSHALL S. REYNOLDS, Individually and as Collector of Internal Revenue, PETITIONER

v.

BARBARA V. COOPER

No. 229

MARSHALL S. REYNOLDS, Individually and as Collector of Internal Revenue, PETITIONER

v.

RICHARD F. COOPER and BARBARA V. COOPER

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

Brief for Respondents

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Brief of Respondents

QUESTION PRESENTED

A more accurate statement of the abstract question presented in these cases would be: whether the provisions of the Revenue Act of 1921, Section 214 (a), that "in computing net income there shall be allowed as deductions: *** (10) in the case of mines, oil and gas wells * * * * a reasonable allowance for depletion", (42 Stat. 239—241), and the corresponding provisions of the Revenue Acts of 1924 and 1926,

have any applicability at all in the case of oil royalties received by trustees under a testamentary trust and paid over to those who have the full and unrestricted beneficial interests in the entire estate.

SUPPLEMENTAL STATEMENT

In view of the fact that the petitioner's brief contains no argument except by reference to the brief in the case of Helvering v. Falk, No. 225, and that stress appears to be laid, in the latter brief, upon the distinction between the interest of the trustees and those of the beneficiaries, it is deemed proper to supplement the petitioner's statement on this point, showing more fully the nature of the interests vested in the trustees and the beneficiaries and what was actually done under the Cooper will.

The will of A. F. T. Cooper, by which the trust involved in these cases was created, is set forth in the Transcript at pages 41—48, with a codicil at pages 48—50.

The will, in clause 1, revokes former wills and, in clauses 2 and 22, appoints executors and trustees who, by clause 14, were given the residue of the estate with power to sell, call in, collect and convert the same into money.

The object and purpose of this power are implicit in numerous provisions for specific or preferred legacies or bequests (Clauses 3, 4, 5, 6, 7, 12, 13), minor annuities (8, 9, 10), preferred trust funds (6, 11), including a preference of £21,000 in the first part of Clause 2 of the codicil, a special trust for the testator's daughter (15, 16, 18), sundry charges (19, 20), a contingency eliminated at the testator's death (17), regulating investments (21) and explanatory of gifts (23).

Before the taxable periods here involved (1923—1926), all of these dispositions had been completed (R. 37) except the ultimate, residuary disposition provided in Clause 14 of the will, as modified by Clause 2 of the codicil (R. 44—45, 49), under which the trustees held the residue:

> "Upon trust as to one-half part or share for my said son Richard Francis Cooper absolutely and as to one-

fourth part or share for my said son John Hartshorn Cooper absolutely and as to the remaining one-fourth part or share for my daughter Barbara Violet Cooper", (upon the special trust as to this one-fourth part declared in clause 15 of the will).

During the taxable periods involved the trustees, therefore, received and distributed the receipts of oil royalties under the existing lease to the three beneficiaries, as above indicated (R. 38).

For each of the taxable years the trustees made fiduciary returns. A typical form of the return, extracted from the Stipulation (R. 38) and rearranged, for convenience of reference, according to the prescribed forms of return in use, is that for 1927, as follows:

TRUSTEES' FIDUCIARY RETURN (R. 38)
INCOME—1927

Interest on Bank Deposits, etc.		$ 380.35
Rents and Royalties (Oil and Gas):		
Amount received	$99,121.65	
Depletion	39,789.46	
Net Profit		59,332.19
Total Income		$59,712.54

DEDUCTIONS

Taxes paid	$2,281.19	
Other Deductions — Attorney's fees and expenses	3,013.81	5,295.00
Net Income		$54,417.54

BENEFICIARIES' SHARES OF INCOME AND CREDITS

		(Distributions)
	Percentage	Dividends
R. F. Cooper	62.5	$34,010.96
B. V. Cooper	37.5	20,406.58
	100.0	$54,417.54

A like typical form for the same year of the Richard F. Cooper return, upon which the tax was paid, is as follows:

TAXPAYER'S RETURN. (R. 37)
R. F. COOPER INCOME—1927

Income from fiduciaries (as shown in Fiduciary return) $34,010.96

The Commissioner, in assessing the additional tax of Richard F. Cooper, added to his return 62.5% of the depletion deducted in the return of the trustees, viz:

62.5% of $39,789=$24,868.38 (R. 39, par. 6, R. 40, par 7).

The computation made upon this basis resulted in an additional tax of $5,769.82, which was assessed and paid, with penalty and interest, bringing the payment up to $6,465.27. (R. 39, 40).

It is the latter amount, with interest, which the taxpayer seeks to recover on account of the assessment of 1927. The same question arises and is presented in a similar manner with respect to the taxes for each of the other years.[1]

SUMMARY OF ARGUMENT

1. The ultimate question in these cases is whether any depletion shall be allowed to anybody. There is no other interest except the interest of the respondents which would be benefited or to which it could be allocated.

[1]The above typical returns are selected and arranged for convenience of future reference. As no question is raised in this Court except the question arising on this return and common to all the other returns, the case will for simplicity be referred to as the case of Richard F. Cooper.

2. The question is not one of the power of Congress, but whether it was the intent of Congress to tax gross income as distinguished from net income.

3. A conspectus of the relevant statutory provisions for depletion discloses an unmistakable intent to allow depletion in all cases in computing net income to be taxed.

4. Congress since the 16th Amendment has never provided for the taxation of gross income—all the Revenue Acts impose the tax on net income.

5. The express authority for depletion deduction in Sec. 214 of the Revenue Act of 1921 applies to all incomes and is impersonal; beneficiaries are taxable only as individuals.

6. The returns in the present case were made upon the the forms and in accordance with the method prescribed and used in the administration of the Revenue Acts. There was no authority or justification for the action of the Commissioner in surcharging the depletion eliminated in the returns.

7. Distributive shares of beneficiaries where referred to in the Revenue Acts mean distributive income—not capital. The use of the term in the petitioner's brief is confusing and misleading.

8. Under the conditions established by the will of the testator and the dispositions accomplished prior to the taxable periods here involved, the only possible allocation of trust funds, whether income or capital, was to the respondents, and the only possible allocation of depletion, therefore, is to them.

9. The only authorities pertinent to depletion deduction in cases of the class to which these cases belong sustain the respondents' claim.

10. There are essential differences between deductions for depletion, which are inseparable from the production of the income taxed, and deductions of other items enumer-

ated in the Revenue Acts, which may be and often are dissociated from income.

11. Cases in this Court and in the Courts of the several Circuits in which depletion deductions were involved concur in supporting the respondents' claims.

12. In allowing depletion deductions "according to the particular conditions in each case", Congress must have been aware of the common occurrence of oil production operations involving trusts and must have legislated with that condition in mind.

13. Where the interests of beneficiaries arise under active trusts and are, therefore, equitable in their nature, they are still recognized as "property" and have most of the usual incidents of property.

14. What is income in the hands of trustees remains income when transferred to beneficiaries of a trust. Its character does not change.

15. There appears to be no authority in the Statutes or under the decisions of Courts for denial of depletion in the instant cases.

16. While the trustees under the Cooper will were given power of conversion of the properties of the estate, the purpose was manifestly to raise the needful funds to satisfy the testamentary dispositions prior to the residuary devise under which the properties came into their hands. This purpose was accomplished and during the taxable periods the trust had become inactive and was executed by force of the Statute of Uses.

ARGUMENT

1 Question is one of any depletion allowance at all.

The question presented by the petitioner for review in these cases and others assigned for argument in connection with them is stated, rather incompletely we think, in the following form:

"Whether beneficiaries of a trust receiving distribution of income are entitled to deductions for depletion of the mineral property constituting a part of the corpus of the trust." (Petitioner's briefs 2)

In the early part of this brief we have restated the question as follows:

"Whether the provisions of the Revenue Act of 1921, Section 214 (a), that 'in computing net income there shall be allowed as deductions: * * (10) in the case of mines, oil and gas wells * * * a reasonable allowance for depletion', (42 Stat. 239—241), and the corresponding provisions of the Revenue Acts of 1924 and 1926, have any applicability at all in the case of oil royalties received by trustees under a testamentary trust and paid over to those who have the full and unrestricted beneficial interests in the entire estate."

As applied to the Cooper cases we think this statement of the question, while still rather narrow, is a more exact statement of the question presented by the record.

It is true, no doubt, that the question is peculiarly one of statutory construction. The particular Sections of the statute relied upon, however, not only have an environment in the cognate statutory provisions but they have a background in the history of Federal Revenue Legislation which cannot be ignored in any attempt at a comprehensive and just interpretation of these provisions.

After the decision of the case of Pollock v. Farmers Loan and Trust Company, 157 U. S. 429 in 1895 it was accepted as an established constitutional principle that Congress could not impose an income (direct) tax without apportionment. Excises on the privilege of doing corporate business, imposed after that decision, were carefully distinguished by this court as such in contradistinction to income taxes, qua *income* taxes, and several of the decisions cited in the petitioner's brief were concerned with cases of that character and can hardly be considered direct authority on the subject of income taxation. The Sixteenth Amend-

ment removed the restriction as to "taxes on income" but left the constitutional authority, otherwise, where it was before.

2 Question not of power, but of intent, of Congress.

As we understand the petitioner's argument, it involves two propositions, (1) that Congress has power to tax "gross income" and (2) that the Revenue Acts of 1921, 1924 and 1926 do not expressly (specifically) authorize beneficiaries of a trust, as such, to deduct depletion from oil royalty income. For reasons which will sufficiently appear in the argument, we do not deem it necessary or pertinent to discuss the first of these propositions.

It is noteworthy that in the legislation subsequent to the Sixteenth Amendment, imposing income taxes, there has been no attempt to impose taxes on *gross* income. All of the subsequent Acts, we believe, have clearly expressed the purpose to lay the tax on *net* income. The definitions of gross and net income and the prescribed methods of determining them have been substantially uniform with the Revenue Acts of 1921, 1924 and 1926 here involved.

It is also to be noted that these definitions and methods are impersonal, being concerned with the subject-matter rather than with the taxpayer; with things rather than with persons. Wherever in the Statutes the personal situation or relations of the taxpayer call for specific provisions, these are to be found either in separate regulations or in modifications of other general provisions. From the very nature of tax legislation the taxes and the subjects of taxation must be described in general and abstract terms. It would be physically impossible for Congress to frame a legislative Act dealing with property, incomes, transactions or methods of administration otherwise than in this manner. The utmost that has been attempted is to reduce these elements to a few comprehensive classifications.

3 Conspectus of relevant statutory provisions.

A brief conspectus of the relevant statutes under which the question in these cases arises will serve to illustrate the argument.

Section 210 of the Revenue Act of 1921 (42 Stat. 227) provides that "there shall be levied * * * upon the *net income* of every individual" (a normal tax); and Sec. 211, in similar language, imposes a surtax.

A "taxpayer" is defined in Sec. 2 (1) (10) as including "any person, trust or estate subject to tax" (42 Stat. 227).

Sec. 212 (a) provides that "in case of an individual the term 'net income' means the gross income as defined in Sec. 213, less the deductions allowed by Sec. 214". (42 Stat. 237).

Sec. 213 provides that "the term 'gross income' (a) includes * * * gains, profits and income derived from any source whatever". (42 Stat. 237—8).

Sec. 214 (a) provides that "in computing net income there shall be allowed as deductions: * * *
(10) In the case of mines, oil and gas wells * * * a reasonable allowance for depletion." (42 Stat. 239—241).

Sec. 219 (a) provides that "the tax imposed by Sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust including * * *
(4) Income which is to be distributed to the beneficiaries periodically. * * *

(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in Sec. 212 (except that in lieu of the deduction authorized by paragraph (11) of subdivision (a) of Sec. 214) there shall be allowed (charitable contributions, *without limitation*, etc.). * * In cases in which there is any income of the class described in paragraph (4), of subdivision (a) of this section the fiduciary shall include in the return a statement of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable to each beneficiary * * *. (d) In cases under paragraph (4) of subdivision (a) * * * the tax shall not be paid by the fiduciary, but there shall be included in computing the net income

of each beneficiary that part of the income of the estate or trust * * * which, pursuant to the instrument or order governing the distribution, is distributable to each beneficiary". (42 Stat. 246—7).

It is a fair synopsis of these provisions that every tax is laid upon net income; that net income means gross income less prescribed deductions; that one of these deductions is the depletion sustained in the production of oil; that the net income of a trust is to be ascertained in the same manner as that of an individual; and that distributable income of the trust is to be included in computing the net income of the beneficiary and the tax paid by him as an individual.

4 Gross income must be reduced to net before tax.

The entire argument of the petitioner appears to be built up on the sense in which the term "income" is used in Sec. 219 (b) and (d) supra, requiring the fiduciary to include in his return a statement of the "income" of the trust which is distributable to each beneficiary, and providing that that part of the "income" distributable shall be included in computing the net "income" of such beneficiary.

There would seem to be no reason, from the language of the Statutes, for giving the word, in this connection, any other meaning than that which is used in expressly defining the term "gross income" in Sec. 213 supra, where it is provided that:

> "The term gross income (a) includes * * * income derived from any source whatever".

We understand that this is the meaning given to the term in the petitioner's argument. Under any interpretation that has been suggested, whatever is included in the term "gross income", as thus defined, would seem to be subject to the deductions expressly required to be made in arriving at the net income; and "income from any source whatever" undoubtedly includes income received by a beneficiary under a trust. In every case gross income before it is subjected to the tax must be reduced to net income. A beneficiary is

not less an individual and, a taxpayer because he happens to receive his income through a trust. Moreover, there is in such case, as it were, a double sanction for the deduction claimed, first, by the trust and, second, by the beneficiary, both of whom are classified as taxpayers. Of course, we do not mean by this a second deduction of the same allowance, but that alternative methods of allowing the deduction are possible under the Statute.

The Statute does not seem to admit of any other practical interpretation of the provision of Sec. 219 (d) that:

> "There shall be included *in computing the net income* of each beneficiary that part of the income of the estate or trust * * * which * * * is distributable to each beneficiary."

The net income of the beneficiary is still "to be computed". But this Section furnishes in itself no method for making the computation. It is only by reference to the provisions of Sec. 214 that any method can anywhere be found for making the computation. The latter Section is explicit in allowing the depletion deduction.

We think the provisions of the statute invoked by the Government, even when considered without reference to other provisions or to the inherent nature of the subject-matter, thus refute the Government's contention. But more especially when considered in the light of the frame-work, purpose and spirit of the Revenue Acts and the methods prescribed for applying them to individual cases and for ascertaining the specific subject of the tax, the error involved in the Government's contention appears still more emphatically.

5 Express authority for depletion deduction applies to all taxpayers.

The key to the petitioner's argument for disallowance of the depletion deduction is contained in the second Specification of Error at page 5 of the brief in No. 225, that there is no (express) statutory authority in the Revenue Acts for

the allowance of such deduction "to beneficiaries of a trust who receive distributions of trust income but have no remainder interest in the corpus of the trust"; and this is reiterated at pages 6, 11 and 13 of the brief.

This argument implies that such a beneficiary is to be distinguished from the "individual" taxpayer mentioned in Secs. 210, 211 and 212 supra. But these Sections contained the only authority for imposing a tax at all. It is true that Sec. 219 provides that as to certain income the tax shall be paid by the beneficiary, but unless this has reference to the Sections above cited, imposing and defining the tax, there is nowhere any declaration of what tax is to be paid. We think that a beneficiary is necessarily subsumed under the provisions of Secs. 210, 211 and 212; and, in turn, these Sections make clear that the deductions provided in Sec. 214, supra, apply. In other words, the beneficiary is a "taxpayer", an "individual", a "person", subject to taxation upon the net income at the rates and by the methods prescribed in those Sections. Otherwise there is no way of ascertaining from the Statutes either the subject-matter or the rate of taxation or of applying it to the party responsible for the payment. The Statute, of course, does not undertake to repeat, in connection with every different species of taxpayer, all of the provisions for computing and ascertaining the tax. To do this would make the Statute intolerably prolix and introduce further confusion into a subject which, as the voluminous litigation over income taxes shows, already presents many and serious difficulties.

At page 13 of the petitioner's brief in No. 225 and in the footnote attention is called to the fact that express provision was made in the Statute (Rev. Act 1921, Sec. 219 (d) etc. and Sec. 204 (c) etc.) for certain "deductions" by the beneficiary, and this is made the occasion for the application of the maxim, "Expressio unius est exclusio alterius." We think counsel overlooks the reason and mistakes the purport of these provisions. The provisions in Sec. 219 (d) etc. relates to the *apportionment* of *credits* under Sec. 216 (a) and (b) for normal tax purposes only. The provision in Sec. 204 (c) etc. relates to net losses of previous years. Under

the terms of Sec. 212 (a) defining "net income" and prescribing the method of ascertaining it only the deductions prescribed in Sec. 214 would be allowable. The allowances referred to in the brief are special allowances of a different character from those specified in Sec. 214 and are, for the most part, personal to the taxpayer, and, in the case of trusts, may require apportionment among several beneficiaries. The reason for these particular provisions is, therefore, apparent. They manifestly have no relation to the class of deductions in which depletion is included.

6 Returns made conformably to prescribed methods.

It is obvious that, in a technical sense, the royalties may be considered as gross income (1) of the trust, or (2) of the beneficiaries.

If the former view is to be taken the question of the allowance of depletion arises immediately upon the return of the trustees. Under Sec. 213 (Revenue Act of 1921, 42 Stat. 238) the trustees should return the gross sum received. Under Sec. 214 (a) they should deduct "a reasonable allowance for depletion" as was done in these cases. Under the same authority they should, in addition, deduct the amount distributable to the beneficiaries. (Sec. 219 supra). This also was done. The return as to the oil royalties was made upon the prescribed form of the Bureau of Internal Revenue, an outline of which appears on page 3 supra.

The beneficiaries also were required to make returns, and they did so, reporting receipts from the source indicated in the amount of the net income distributed to them, as shown by the fiduciary return. Should they also have included the sums deducted by the trustees for depletion?

It is to be remembered that the tax returns are returns of *income*. If the deduction made by the trustees was a proper and lawful one, it amounted, in substance, to a segregation of their receipts between income and capital. That is the evident purpose of the method prescribed for making the returns and the only purpose which can be attributed to the statutes allowing depletion deduction. Any other

view of the subject reduces the return to a mere form, without substantial significance.

If, then, the return of the trustees was properly made and the segregation between capital and income authorized, it seems to follow that the amount designated as "depletion" came to the beneficiaries as a distribution of capital—"the value of property acquired by bequest or devise", which is excluded from taxation by Sec. 213 (b) (3), (42 Stat. 238).

These amounts were not in any substantial sense "income" unless through some magic influence in passing from the hands of the trustees to those of the beneficiaries they were converted from bequest of capital to income.

7 Distributive shares means distributive incomes—not capital.

At page 15 of the brief it is suggested that:

> "The beneficiaries of the trust might receive distributions of proceeds of the sale of the property constituting the corpus of the trust, as well as distributions of income arising therefrom."

In that case we suppose such receipts would be considered a part of the beneficiary's "distributive share". And at page 13 of the same brief it is said that "the statute makes the beneficiary taxable on his distributive share and on all of his distributive share." Share of what? Is the Court to be precluded from looking to the origin and nature of the distributive share to determine whether it is capital or income, or must the taxpayer, merely because he happens to be a beneficiary of a trust, be taxed under the guise of "income" upon all of the proceeds?

Let us illustrate the point further by supposing that the trustees had sold and disposed of the entire residuary estate leaving in their hands the price to be distributed in pursuance to the will. Under all of the Revenue Acts the capital value at the time the will became effective would be taken as the cost of the property and would be deductible from the proceeds before it could be determined whether any gain had

been realized or not. Yet the proceeds in such case would have been as much "the distributive shares" of the beneficiaries as in the case of income distributed from royalties. It appears to us that this illustration demonstrates the error involved throughout the petitioner's brief in using the term "distributive share" in lieu of the term "income."

8 Only possible allocation of depletion is to these taxpayers.

With noteworthy generosity the Government seems to concede, for the purposes of this case, that the depletion deduction may be made by the trustees as distinguished from the beneficiary. This concession is not so surprising since the result would be, if the contention of the petitioner is carried to its conclusion, that no effective deduction could be made by anybody. As the supplemental statement supra shows, the deduction was made by the trustees in the returns actually filed. It is insisted, however, that when the proceeds reached the hands of the beneficiary the trustees' deduction must be nullified and the amount restored as taxable income without any right on the part of the beneficiary to take the allowance.

It may be that the contention would not be carried to the extreme point that where two beneficiaries were concerned, one having a life interest and the other a remainder, the remainderman would be obligated to treat the depletion reserve as income without benefit of deduction. But if the deduction were conceded in such case, there seems to be no reason in principle why it should not be conceded where there is but one interest for life and remainder merged in a single individual. No logical reason is suggested why different principles should apply in the different circumstances illustrated.

At page 17 of the petitioner's brief the contention seems to be made that Congress, in the Revenue Act of 1928, sanctioned the interpretation of previous Revenue Acts which is now asserted on the part of the Government.

In the Revenue Act of 1928 (Sec. 23 (1)), the provision of the Revenue Act of 1921 (Sec. 214, (a) (10)) for depletion deduction, was reenacted with the addition of a provision for allocating the deduction (a) as between life tenant and remainderman, and (b) between trustee and beneficiary, in the former instance allocating the deduction to the life tenant and in the latter authorizing apportionment between trustee and beneficiary:

> "In accordance with the pertinent provisions of the instrument creating the trust, or in the absence of such provisions on the basis of the trust income allocable to each." (45 Stat. 800)

In other words, the deduction was neither granted nor withheld, increased nor diminished, by the later Act. A specific rule of apportionment was provided. As between the life tenant and the remainderman, it perhaps favored the former as against the latter, as compared with the rule which had been adopted by the courts. As between the trustee and the beneficiary it established an explicit rule, where formerly the rule had been implicit.

It seems to us a natural and reasonable conclusion, from this examination of the statutes, that the purpose and scope of the legislation as a whole is to tax only net income, irrespective of the incidence of the tax as between the particular taxpayers, and that the provisions, both inclusive and exclusive, are formed with the purpose of ascertaining that residuum; that the tax is then laid upon the residuum and apportioned, as equitably and appropriately as may be, among the taxpayers by whom the income is received and enjoyed; that beneficiaries of a trust, as they are held to all of the responsibilities and obligations of other individual taxpayers, are entitled to the corresponding rights and benefits of the methods established for a uniform and equitable distribution of the tax burden; and that the admitted depletion in this case in the process of realizing the value of the mineral resources should be allowed as a deduction, either upon the returns of the trustees or those of the taxpayers—the only possible allocation in the circumstances shown.

9 The only pertinent cases support respondents' claims.

While these conclusions have been reached without special reference to the authority of decided cases, it is believed that they are fully sustained by a substantial unanimity of the decisions applicable to the conditions and circumstances shown in this case. We believe no instance is to be found where depletion has not ultimately been allowed as a deduction to taxpayers who sustained similar relations to the trust fund to those occupied by the taxpayers in this case. There are, to be sure, cases in which deductions by the beneficiaries have been disallowed but they are cases broadly distinguishable from the case at bar and fall generally into two classes:

1. Cases in which the deductions claimed were essentially different in their nature from deductions for depletion.

2. Cases in which, by reason of distinct beneficial interests or estates, deductions have been denied in favor of one class as against other classes of beneficiaries.

10 Essential differences between classes of deductions.

It may be useful here to point out some of the distinctions between the different classes of deductions allowed. These distinctions are believed to be inherent in the nature and subject-matter of the deductions and the grounds on which they rest.

In dealing with the general subject of deductions throughout the petitioner's brief no distinction is made between deductions for depletion, depreciation, operating losses, capital losses, etc. Yet there are manifest differences of a fundamental nature, so far as the allowance is concerned.

Depletion is a wasting process, inseparably linked with the production, from which the income is derived. The exhaustion of the substance is inherent in the very process. The substance is disposed of and paid for and the price included in the proceeds.

Depreciation may or may not arise in the process. It may wholly or partly result from mere lapse of time. It may relate to wholly different property or assets. It may be proportioned or disproportioned to the substance removed. Its association with depletion, production or operation is merely casual.

Operating losses bear no direct relation to depletion. They may bear no relation whatever to it. Ordinarily they are personal to the operator and dependent upon his skill, diligence, good or bad fortune, or other extraneous conditions.

Capital losses are ordinarily not associated at all with the operation of production. They usually arise upon sale but may be the result of other causes adventitious to or wholly independent of the productive enterprise.

11 Cases involving depletion deductions.

A reference to the several cases which have been before this Court under the Revenue Acts since the Sixteenth Amendment will disclose that the government has steadily resisted the application of those provisions of the Statutes which were deemed advantageous to the taxpayer in determing his taxable income and has insisted upon a strict limitation of allowances for depletion, as well as other deductions, to cases where the Statutes are so specific that the matter does not admit of debate.

A leading case on this subject is Lynch v. Alworth-Stephens Co., 267 U. S. 364, where depletion deduction was claimed by the lessee of a mine who had sublet upon terms of over-riding royalty. That case is cited by the petitioner here in an effort to distinguish the position of the intermediate lessee from that of the beneficiary of the trust involved in the present cases.

It is not, however, merely the language of the Opinion in that case which is significant but the fully reasoned application of the Statutes to a situation which, in its essenti-

als, is comparable with the situation of the present respondents. The court said:

> "There is nothing to suggest that the word 'property' is used in any restricted sense. In the case of mines, a specific kind of property, the exhaustion is described as depletion, and is limited to an amount not exceeding the market value in the mine of the product mined and sold during the year. The interest of respondent under its leases in the mines being property, its right to deduct a reasonable allowance for exhaustion of such property, if there be any, during the taxable year, results from the plain terms of the statute, * * *. We agree with the Circuit Court of Appeals that 'the plain, clear, and reasonable meaning of the statute seems to be that the reasonable allowance for depletion in case of a mine is to be made to everyone whose property right and interest therein have been depleted by the extraction and disposition of the product thereof which has been mined and sold during the year for which the return and computation are made.' And the plain, obvious, and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover.
>
> "It is said that the depletion allowance applies to the physical exhaustion of the ore deposits, and since the title thereto is in the lessor, he alone is entitled to make the deduction. But the fallacy in the syllogism is plain. The deduction for depletion in the case of mines is a special application of the general rule of the statute allowing a deduction for exhaustion of property. While respondent does not own the ore deposits, its right to mine and remove the ore and reduce it to possession and ownership is property within the meaning of the general provision. Obviously, as the process goes on, this property interest of the lessee in the mines is lessened from year to year, as the owner's property interest in the same mines is likewise lessened. There is an exhaustion of property in the one case as in the other; and

the extent of it, with the consequent deduction to be made, in each case, is to be arrived at in the same way."

The latest case which has come to our notice is Palmer v. Bender, 287 U. S. 551, involving a somewhat similar transaction. In that case a partnership, of which the taxpayer was a member, owned an oil lease in Louisana, and transferred the leased premises to an operating company, reserving a proportion of the oil to be produced. The taxpayer claimed a depletion allowance of his share of the proceeds of oil produced. This Court sustained his contention, saying, inter-alia:

"It has been elaborately argued at the bar and in the briefs whether under Louisiana law the two instruments (involved in the transaction) are assignments or subleases. We do not think the distinction material. * * * It will be observed that the statute directs that reasonable allowance for depletion be made as a deduction in computing net taxable income, 'in the case of oil and gas wells, * * * according to the peculiar conditions in each case.' The allowance to the taxpayer is not restricted by the words of the statute to cases of any particular class or to any special form of legal interest in the oil well. It is true that under Article 215 of Treasury Regulations 62 the lessor of an oil or gas well is entitled to a depletion allowance upon the bonus and royalties received from the lessee. See Murphy Oil Co. v. Burnet, 287 U. S. 299, ante, 318, 53 S. Ct. 161, supra. But there is nothing in the statute or regulations which confines depletion allowances to those who are technically lessors. The concluding sentence of the section that 'In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and the lessee' presupposes that the deductions may be allowed in other cases. The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the ex-

traction of the oil, to which he must look for a return of his capital."

The Court referred to Lynch v. Alworth-Stephens Co., supra, saying:

> "The statute made no specific reference to lessees and the Government argued that as the lessee acquired no ownership of the ore until the severance from the soil * * * the lease gave him no depletable interest in the ore in place. But this Court held that regardless of the technical ownership of the ore before severance, the taxpayer, by his lease, had acquired legal control of a valuable economic interest in the ore capable of realization as gross income by the exercise of his mining rights under the lease. Depletion was, therefore, allowed."

Continuing, in the Palmer case, the Court said:

> "Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough, if by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production. Thus, we have recently held that the lessor is entitled to a depletion allowance on bonus and royalties, although by the local law ownership of the minerals, in place, passed from the lessor upon the execution of the lease. * * *
>
> "In the present case the two partnerships acquired, by the leases to them, complete legal control of the oil in place. Even though legal ownership of it, in a technical sense, remained in their lessor, they, as lessees, nevertheless acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute. Lynch v. Alworth-Stephens Co. 267 U. S. 364, 69 L. ed. 660, 45 S. Ct. 273, supra. When the two lessees transferred their operating rights to the two oil companies, whether they became technical sub-

lessors or not, they retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor, Burnet v. Harmel, and Bankers Pocahontas Coal Co. v. Burnet, supra. Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees, were entitled to share in the oil produced. Production and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests. The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case of oil and gas wells of a reasonable allowance for depletion according to the peculiar conditions in each case."[1]

12 Allowances "according to particular conditions in each case."

The Court seems, in the Palmer case, to have noted the provision in the Statute for the allowance of a depletion deduction "according to the peculiar conditions in each case"; and, we think, this phrase ought to be accorded its meed of significance in applying the provision to any case. The import of the Statutes seems to be plain that a variety of conditions was in the legislative mind. Trusts, like leases, have been so very numerous and common in transactions of this kind, and this fact has been of such wide spread general knowledge, that such interests must be deemed to have been included in the purview of Congress. The provision has been reenacted in successive Revenue Acts over a period of years when cases of this character have been before the Courts.

[1]Whatever is said in this and other cases concerning ownership or other interests in oil or gas must, of course, be taken with reference to the qualified sense in which property interests in those fugitive substances are to be understood. Brown v. Spilman, 155 U. S. 665, Ohio Oil Co. v. Indiana, 177 U. S. 190.

Doubtless the only reason why the provision was not made more specific and detailed at the outset was the fear that any attempt of this kind would be more likely to defeat than to promote the purpose in view, by narrowing the scope of the Statutes to the specifications.

If it be contended, as the petitioner's brief imports, that a beneficial interest in an active trust is beyond the pale of this legislation, reference may profitably be made to other cases.

13 Property interests include equitable interests.

This Court has expressed what we believe to be the general doctrine, that such interests are property, whether considered as direct equitable interests in the corpus or as interests only in the income of the corpus, to the extent of the terms of the grant. In the case of Bryan v. Kennett, 113 U. S. 179, the Court, speaking of the relationship sustained by the United States as trustee for the inhabitants of the Territory of Louisiana and of the interest of the inhabitants due to such relationship, said:

> "The term 'property' as applied to lands, comprehends every species of title, inchoate or complete,"

and approved a statement in a previous decision that:

> "This court has defined property to be any right, legal or equitable, inceptive, inchoate or perfect, which before the treaty with France in 1803 * * * had so attached to any piece or tract of land, great or small as to affect the conscience of the former sovereign 'with a trust' and make him a trustee. * * * By the term 'property' applied to lands all titles are embraced, legal or equitable, perfect or imperfect."

As was said in Lynch v. Alworth-Stephens Co., supra:

> "There is nothing (in the Revenue Acts) to suggest that the word 'property' is used in any restricted sense. * * * The plain, clear and reasonable meaning of the statutes seems to be that the reasonable allowance for depletion in case of a mine is to be made to everyone

whose property right and interest therein have been depleted by the extraction and disposition of the product." In Irwin v. Gavit, 268 U. S. 161, 167, the Court said:

> "A gift of the income of a fund ordinarily is treated by equity as creating an interest in the fund. Apart from technicalities, we can perceive no distinction relevant to the question before us between a gift of the fund for life and a gift of the income from it."

14 Income of trustees is income of beneficiaries.

This was said in connection with a discussion by the Court as to whether the character of the proceeds was changed in passing from the hands of the trustees to that of the beneficiaries:

> "The money was income in the hands of the trustees, and we know of nothing in the law that prevented its being paid and received as income by the donee."

In other words, as we have already suggested, supra p. 14, the character of the receipts as income, and, as we believe, the method of determining income, are not changed or affected by the character of the interest or the relation of the recipient as trustee or beneficiary. These are to be determined impersonally from the nature of the fund itself, rather than by the technical trust relations.

An illustration of the view which this Court takes concerning the importance of the technical relations with which a trust fund may be surrounded is found in Lederer v. Stockton, 260 U. S. 1, where a trustee holding a fund, the ultimate beneficiary of which was a charitable corporation, was precluded, by technical reasons, from paying the income directly to such beneficiary. To avoid this difficulty the trustee loaned the fund to the beneficiary and the Government sought to collect a tax from the trust on the income. The Court said:

> "To allow the technical formality of the trust, which does not prevent the hospital from really enjoying the income [to avoid the exemption], would be to defeat the beneficient purpose of Congress."

The Courts of at least three of the Circuits have specifically upheld the right of the beneficiary of a trust entitled to receive the income and to share in some form in the corpus of the trust to take deduction allowance for depletion.

Second Circuit:

Merle-Smith v. Commissioner, 42 Fed. (2d) 837, Certiorari denied 282 U. S. 897

Seventh Circuit:

Falk v. Com., 64 Fed. (2d) 171

Tenth Circuit:

Com v. Molter, 60 Fed. (2nd) 498
Cooper v. Reynolds, 60 Fed. (2d) 650
Reynolds v. Cooper, 64 Fed. (2d) 644

An illustration of the application of the depletion allowance "according to the peculiar conditions in each case" is found in Signal Gasoline Corporation v. Com., 66 Fed. (2d) 886, (9 C.C.A.) which the taxpayer had casing-head gas contracts with several oil producing companies and claimed depletion deduction on the capital value of his rights under the contracts.

The decision of this Court in Palmer v. Bender, supra, was applied and the deduction allowed, the Court saying:

> "The right to a depletion allowance does not depend upon the nature or character of the legal estate retained or acquired by the parties to an original oil and gas lease or their successors, but depends entirely upon whether any such parties are entitled to share in the oil and gas produced from the properties. If any of such parties are entitled to a share of the oil and gas, he had the 'economic interest' upon which the Supreme Court bases the right to a depletion allowance."

In recent cases the Board of Tax Appeals follows the same rule.

Alphin v. Com., 21 B. T. A. 1101
Kuhn v. Com., 24 B. T. A. 216

The Bureau of Internal Revenue seems now to recognize the same rule.

C. B. X-2, 353 (G. C. M. 9804)
C. B. XI-1, 161, 169 (G. C. M. 10,273)

15 No authority for denial of depletion in instant cases.

We do not know of any authority, at least among recent cases, dealing with the subject of depletion, which conflicts with the rule established by the cases above cited. The leading citation in the petitioner's brief is that of Baltzell v. Mitchell, 3 Fed. (2d) 428, Certiorari denied 268 U. S. 690. It was a case involving a capital loss and the taxpayer's claim was denied on the ground that the beneficiaries of the trust had only a life interest in the fund and were, therefore, not interested in capital gains or losses, although one of the beneficiaries had a "vested, equitable remainder" in the estates; which is substantially in accord with the decision reached by this Court in Anderson v. Wilson, infra.

Similar results were reached under slightly varying conditions in other cases cited by the petitioner.

The case of Anderson v. Wilson, 289 U. S. 20, which petitioner's counsel seem to regard as pertinent to the present cases, involved a claim of the taxpayer in his return to deduct a share of the loss realized on the sale of a building constituting part of the residuary estate of his father. The Courts decided that the residuary estate was held in trust. The facts, as gathered from the three Reports (51 F. (2d) 268, 60 F. (2d) 52, and 289 U. S. 20) and from the briefs of counsel, were substantially as follows:

Out of a large estate $2,500,000 was given to a separate trustee; and the executors were directed to hold and manage the residue of the properties until, in their judgment, they could be advantageously disposed of but not beyond the lives of his sons; and, at discretion, to sell and dispose of them or incorporate the holdings, retaining or distributing the proceeds, in whole or in part, at discreation; and meanwhile to

pay over the net income semi-annually to the residuary devisees.

The special trust fund of $2,500,000 was divided by the will into five equal parts, of one of which the taxpayer was beneficiary. The proceeds of the residuary estate also were divided into five equal parts, one of which, to the amount of $500,000, was set aside, and added to his share of the trust fund, and was to be held for his use during life, with remainder to lineal descendants, etc. The balance of such one-fifth part was given to the taxpayer absolutely.

Prior to the taxable year (1922) the debts had been paid and all of the estate had been distributed except properties valued at about $350,000. In that year the building was sold for $165,000, $50,000 of which was distributed and the balance retained by the executors. The sale involved a loss of $113,000, one-fifth of which was claimed by the taxpayer as his share of a deduction from income. The taxpayer's share of the proceeds of the sale of the building was, of course, not taxed; so that the deduction claimed did not come out of the proceeds but was claimed as an offset or deduction from his share of the income proper of the estate. This Court held that the residuary bequest was a trust held by the executors in fee and that the loss was attributable to the trust and not to the taxpayer as a beneficiary, saying:

> "Whether the result would be the same if the beneficiaries had been the owners of future estates in remainder we are not required to determine. * * Our ruling will be kept within the limits of the case before us."

As we understand it, the distinguishing features of the case resided chiefly in the fact that the executors (trustees) still retained the title, custody and management of the estate which they were engaged in managing and liquidating and retained in their hands $115,000 of the proceeds of the sale, together with the properties still undisposed of. There was still outstanding the remainder interest in the trusts, aggregating $1,000,000, of which the taxpayer was the life beneficiary, such remainder interest intervening between the taxpayer's life use and his ultimate interest in the estate. The

loss on the sale was wholly unconnected with the taxpayer's income and even if it formed a part of the capital of the trust in which he was interested he was protected from indirect loss by the preference to the extent of $500,000 given to his life use. Elsewhere in this brief we have attempted to point out some further essential differences between a depletion deduction and a loss deduction. An additional distinction arises from the character of the trust involved in the present cases, which is discussed infra.

The Circuit Court of Appeals in its Opinion in the present cases (64 F. (2) 644) reviewed the authorities cited, and we think distinguished them with care. It had the benefit of the Opinions of this Court in Anderson v. Wilson and Palmer v. Bender, supra, and pointed out the essential difference between a capital loss and depletion, and the comprehensive nature of the interest of the beneficiaries in the present cases. It apprehended clearly the point involved that there was a question not of apportioning the depletion between a trust and the beneficiaries but of allowing any depletion to anybody. We believe that its analysis of the Statutes and its interpretation of the cases was comprehensive and exhaustive and that it reached a correct result.

The point suggested at the threshold of this brief that the contention of the Government if applied to the present case would inevitably result in the disallowance of any depletion to anybody, although the fact and the amount of the actual wastage is admitted, ought not to be lost sight of in the consideration of the cases.

In every other case, we believe, where a deduction from income has been involved the decision of the case has resulted in the allowance to somebody. In cases where the interests of life beneficiaries and remaindermen have been involved, the depletion, where disallowed to the life beneficiary, has been allowed to the trust. The result of this has been that the remainderman ultimately realized the benefit of the deduction. In cases where the life tenant has been the ultimate remainderman he, himself, has realized the ultimate benefit. In other words, what has been taken out of one pocket has been put in the other or in the pocket of another. We be-

lieve there is no case to be found where the benefit of the deduction has been wholly denied.

It is manifest that in the circumstances of the present case there is but one place where the deduction may be made in order to be effective, viz, in determining the net income of the taxpayer beneficiary. It matters not in what particular form the allowance is made or whether it be taken out of the gross income returned by the fiduciaries or out of the receipts treated as gross income in the return of the beneficiary. The result would be precisely the same, to recognize the allowance as one sanctioned by the Statutes the benefit of which must accrue to the respondent.

16 Trust was executed under Statute of Uses.

In all that has been said the subject has been dealt with as though the taxpayer had no right in the fund from which the income proceeds, except the equitable right to participate in distributions of proceeds by trustees holding the legal estate. The facts shown by the supplemental statement, however, put the taxpayer's interest in a different light. (Supra pp. 2-4).

The trustees under the will were given power to sell, call in, collect and convert the properties of the estate into money. The purpose of this power is obvious from a consideration of the scope and provisions of the will. A considerable sum, amounting perhaps to $200,000, was required to be raised out of the assets to take care of preferred testamentary dispositions. That the testator expected the money to come from his oil rights is clear from a reference to the will and codicil. The authority to convert the properties into money is, we think, plainly referred to the need of raising the funds to satisfy the prior bequests. This need, as is shown by the Stipulation of Facts, (R. 37), had been met and the purpose of the authority to convert the properties had, thus, been satisfied prior to the beginning of the taxable periods involved in the present case. During the taxable periods the trustees performed no function except to receive the payments of royalty, to pay the taxes and expenses of the

trust, to pass the residue on to the taxpayers whose interest in the entire residuary estate had become complete and absolute. As the Trial Court said (60 Fed. (2d) 652):

> "The provisions of the will concerning the trust features construed as free from legal technicality, amount to the mere passing of the income accruing from the royalties through the trust to the beneficiaries and, therefore, in substance, the situation is the same as though the beneficiaries were receiving such royalties direct."

In the circumstances shown the trust had thus become fully executed under the Statute of Uses[1]. The legal, as well as the equitable title, was vested in the beneficiaries. There was in effect no trust in existence.

In Young v. Bradley, 101 U. S. 782, where a testamentary trust had been created giving the trustees "the largest powers and discretion in taking charge of and managing" the estate, and authorizing them "to have, hold, direct and control", according to their best judgment, and "to sell and dispose of the same, or any parts thereof, from time to time, subject only to the aforesaid (preferred) trusts" as freely as the testator could do if living, etc., the Court, reciting the events which had happened, including a conveyance by the trustee which was held to be without authority, said:

> "The things to be done by the trustees were defined, and in the nature of things were to have an end. * * * These are all the trusts declared by the will. They were

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[1]R. S. Wyo. 1931, Ch. 26-101, provides that:

"The common law of England as modified by judicial decisions, so far as the same is of a general nature and not inapplicable, and all declaratory or remedial acts or statutes made in aid of, or to supply the defects of the common law prior to the fourth year of James the first (excepting the second section of the sixth chapter of forty-third Elizabeth, the eighth chapter of thirteenth Elizabeth and ninth chapter of thirty-seventh Henry Eighth) and which are of a general nature and not local to England, shall be the rule of decision in this state when not inconsistent with the laws thereof, and shall be considered as of full force, until repealed by legislative authority."

The State has no further Statutes affecting the subject. The law of New York on the subject is specially regulated by legislation, superseding the Statute of Uses, enacted early in the 19th Century, which has been substantially followed in Michigan, Wisconsin, Minnesota, California and Dakota. 2 Pom. Eq. Jur. 1003.

all performed, superseded or terminated before the deed to Young was made. The trustee in making that deed was discharging no trust reposed in him and no duty required of him by the will. It is not suggested anywhere that any such purpose was in view. It is said that the property was dilapidated and needed repair. But as it belonged to Mrs. Bradley and her children, and as the will did not confer on the trustees any guardianship or control over the property of Bradley's children after their share was allotted to them, the trustees had no power over it when it came to them by the other provisions of the will on the death of the other devisees.

"The doctrine is well settled that, whatever the language by which the trust estate is vested in the trustee, its nature and duration are governed by the requirement of the trust. If that requires a fee simple estate in the trustee, it will be created, though the language be not apt for that purpose. If the language conveys to the trustee and his heirs forever, while the trust requires a more limited estate either in quantity or duration, only the latter will vest."

To similar effect see:

Carwardine v. Carwardine, 1 Eden 27, 28, Eng. Rep. 594, 597

Doe v. Simpson, 8 De G. M. and G. 521, 102 Eng. Rep. 1031

Morrant v. Gough, 1 Man. & Ry. 41, 108 Eng. Rep. 700, 702

In an earlier part of this brief (supra p. 13) we have called attention to some of the expressions in the Opinions of this Court concerning the nature of equitable rights as property. The principle there referred to may be carried somewhat further in this connection. In Croxall v. Sherrerd, 5 Wall. 268, the Court said:

"In the law, if real property, the principles which apply to estates of both kinds, (legal and equitable), with a few limited exceptions not affecting this case,

are the same. In the consideration of a court of equity the cestui que trust is actually seized of the freehold. He may alien it and any legal conveyance by him will have the same operation in equity upon the trust as it would have had in law upon the legal estate. * * * The trust, like the legal estate, is descendible, devisable, alienable and barrable by the act of the parties and by matter of record. Generally whatever is true at law of the legal estate is true in equity of the trust estate."

See also:

Town of Cascade v. Cascade County, 75 Mont. 304

Cushing v. Blake, 30 N. J. Eq. 689, 695

Zelley v. Zelley, ...N. J. Eq.....136 A. 738

Arnold v. Southern Pine Lumber Co., 58 Tex. Civ. App. 186

For the reasons set forth, it is submitted that the decisions of the Circuit Court of Appeals should be affirmed.

Respectfully submitted.

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